International Business
Global Edition

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(adapted for LIUC2015 by R.Helg)

Chapter 8

Foreign Direct Investment

Introduction

- Foreign direct investment (FDI) occurs when a firm invests directly in new facilities to produce and/or market in a foreign country
- Once a firm undertakes FDI it becomes a multinational enterprise
- Two main forms of FDI:

1) **Merger & Acquisition**: company acquiring or merging with a firm in a different country
2) **Greenfield investment**: a firm creating a new operation in a different country (the most important form in emerging economies)

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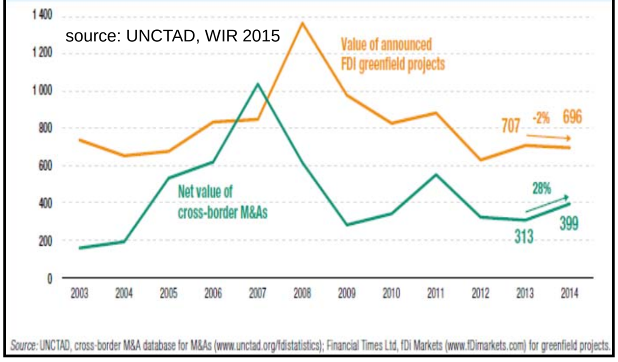
M&A vs greenfield FDI



What Is FDI?

- The flow of FDI - the amount of FDI undertaken over a given time period
  - Outflows of FDI are the flows of FDI out of a country
  - Inflows of FDI are the flows of FDI into a country
- The stock of FDI - the total accumulated value of foreign-owned assets at a given time

8-5

Trends in FDI

1) Flow and stock increased dramatically in the last 20 years

- In spite of decline of trade barriers, FDI has grown more rapidly than world trade because
  - Businesses fear protectionist pressures: FDI is seen as a way of circumventing trade barriers
  - Globalization of the world economy has raised the vision of firms who now see the entire world as their market

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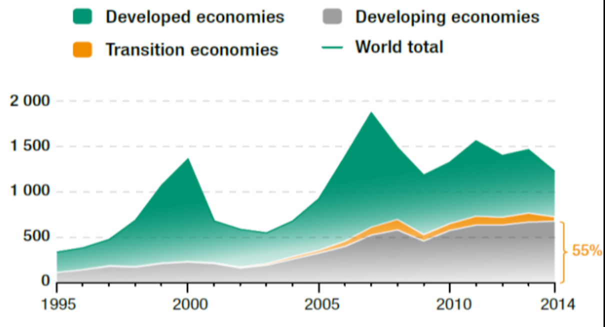
FDI: overall evolution

source: UNCTAD, WIR 2015



Source: UNCTAD, FDI/MNE database (www.unctad.org/fdistatistics).

Trends in FDI: slumping FDI

- **Two recent slumps**:

i) Between 2000 and 2004 the value of FDI slumped almost 50% from $1.4 trillion to less than $600 billion

it reflected three developments

a) General slowdown of the world economy

b) Heightened geopolitical uncertainty following the September 11, 2001 attack

c) Bursting of the stock market bubble in the US

ii) Slump in FDI reappeared in **2008 and 2009** because of the financial crisis. Again World FDI declined by almost 50%

Trends in FDI: the destination of FDI

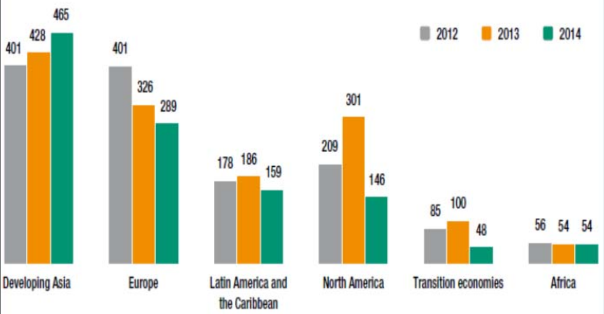
2) Historically, most FDI have been directed at the developed nations, but after 2010 this has changed

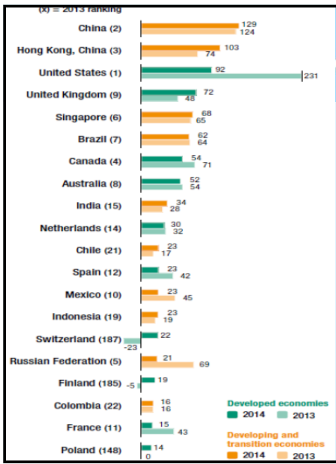
The US has been the favorite target for FDI inflows

- Emerging countries have increased their role as destination area.

Inflows of FDI by region

(source WIR 2015)





Trends in FDI: the destination of FDI by country

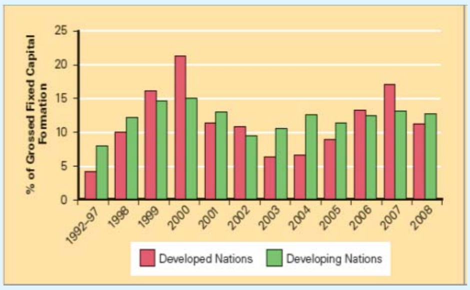
Fonte: UNCTAD, WIR 2015

Trends in FDI: the destination of FDI

- Gross fixed capital formation summarizes the total amount of capital invested in factories, stores, office buildings, and the like
- All else being equal, the greater the capital investment in an economy, the more favorable its future prospects are likely to be
- So, FDI can be seen as an important source of capital investment and a determinant of the future growth rate of an economy

What Are The Patterns Of FDI?

Inward FDI as a % of Gross Fixed Capital Formation 1992-2008



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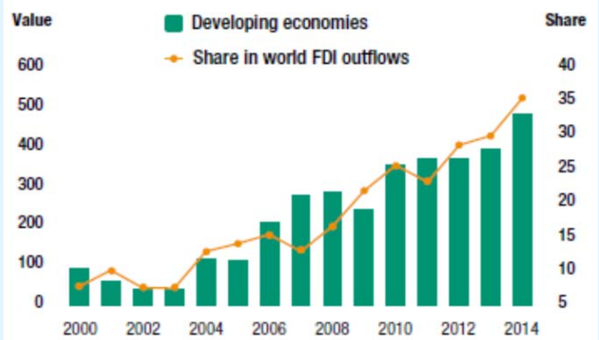
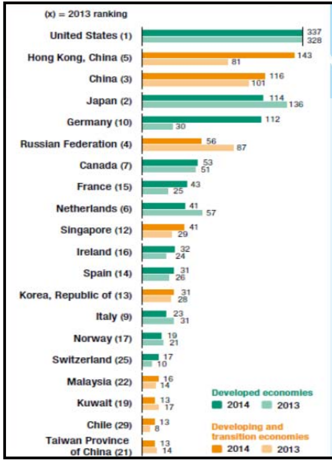
What is the source of FDI?

3) Since World War II, the U.S. has been the largest source country for FDI

- China, France, Germany, Japan, the Netherlands, Switzerland, the United Kingdom are other important source countries
- together, these countries account for 56% of all FDI outflows from 1998-2006, and 61% of the total global stock of FDI in 2007

The role of emerging countries in world FDI outflows





Trends in FDI: the source of FDI by country

Fonte: UNCTAD, WIR 2014

8-16

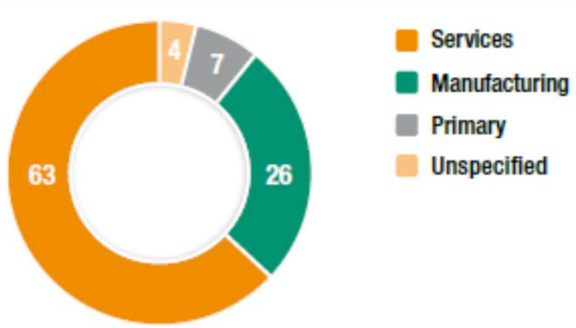
Trends in FDI: the shift to Services

4) FDI is shifting away from extractive industries and manufacturing, and towards services. Before the crises **in 2007 64% of FDI stock was in services (up from 49% in 1990). In 2012 services were 63%.**

- The shift to services is being driven by
  - the general move in many developed countries toward services
  - the fact that many services need to be produced where they are consumed
  - a liberalization of policies governing FDI in services
  - the rise of Internet-based global telecommunications networks

8-17

Global inward FDI stock by sector (%): 2012



Two forms of FDI

- **Horizontal Direct Investment (HFDI)**
  - FDI in the same industry abroad as company operates at home.
- **Vertical Direct Investment (VFDI)**
  - **Backward** - investments into industry that provides inputs into a firm's domestic production (typically extractive industries)
  - **Forward** - investment in an industry that utilizes the outputs from a firm's domestic production (typically sales and distribution)

7-19

Why do firms choose M&A versus Greenfield Investments?

- Most cross-border investment is in the form of mergers and acquisitions rather than greenfield investments
- Firms prefer to acquire existing assets because
  - mergers and acquisitions are quicker to execute than greenfield investments
  - it is easier and perhaps less risky for a firm to acquire desired assets than build them from the ground up
  - firms believe that they can increase the efficiency of an acquired unit by transferring capital, technology, or management skills

7-20

Why Choose FDI?

- Question: Why does FDI occur instead of exporting or licensing?

1. Exporting - producing goods at home and then shipping them to the receiving country for sale
   - exports can be limited by transportation costs and trade barriers
   - FDI may be a response to actual or threatened trade barriers such as import tariffs or quotas

8-21

Why Choose FDI?

2. Licensing - granting a foreign entity the right to produce and sell the firm's product in return for a royalty fee on every unit that the foreign entity sells

- Internalization theory (aka market imperfections theory) suggests that licensing has three major drawbacks compared to FDI:
  - firm could give away valuable technological know-how to a potential foreign competitor
  - does not give a firm the control over manufacturing, marketing, and strategy in the foreign country
  - the firm's competitive advantage may be based on its management, marketing, and manufacturing capabilities

8-22

What Is The Pattern Of FDI?

- Question: Why do firms in the same industry undertake FDI at about the same time and the same locations?
- Knickerbocker - FDI flows are a reflection of strategic rivalry between firms in the global marketplace
  - multipoint competition -when two or more enterprises encounter each other in different regional markets, national markets, or industries
- Vernon - firms undertake FDI at particular stages in the life cycle of a product

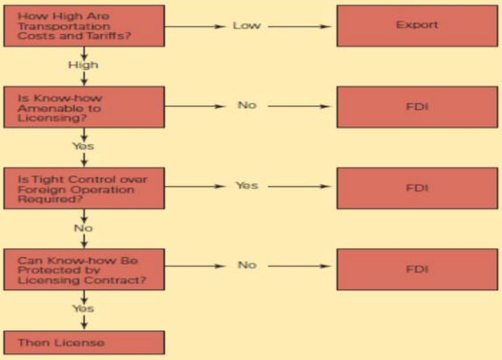
8-23

What Is The Pattern Of FDI?

- Question: But, why is it profitable for firms to undertake FDI rather than continuing to export from home base, or licensing a foreign firm?
- Dunning's eclectic paradigm - it is important to consider
  - location-specific advantages - that arise from using resource endowments or assets that are tied to a particular location and that a firm finds valuable to combine with its own unique assets
  - externalities - knowledge spillovers that occur when companies in the same industry locate in the same area

8-24

What Does FDI Mean For Managers?



How Does FDI Benefit The Host Country?

- There are four main benefits of inward FDI for a host country

1. Resource transfer effects - FDI brings capital, technology, and management resources
2. Employment effects - FDI can bring jobs

8-26

How Does FDI Benefit The Host Country?

3. Balance of payments effects - FDI can help a country to achieve a current account surplus
4. Effects on competition and economic growth - greenfield investments increase the level of competition in a market, driving down prices and improving the welfare of consumers
   - can lead to increased productivity growth, product and process innovation, and greater economic growth

8-27

What Are The Costs Of FDI To The Host Country?

- Inward FDI has three main costs:

1. Adverse effects of FDI on competition within the host nation
   - subsidiaries of foreign MNEs may have greater economic power than indigenous competitors because they may be part of a larger international organization

8-28

What Are The Costs Of FDI To The Host Country?

2. Adverse effects on the balance of payments
   - when a foreign subsidiary imports a substantial number of its inputs from abroad, there is a debit on the current account of the host country's balance of payments
3. Perceived loss of national sovereignty and autonomy
   - decisions that affect the host country will be made by a foreign parent that has no real commitment to the host country, and over which the host country's government has no real control

8-29

How Does FDI Benefit The Home Country?

- The benefits of FDI for the home country include

1. The effect on the capital account of the home country's balance of payments from the inward flow of foreign earnings
2. The employment effects that arise from outward FDI
3. The gains from learning valuable skills from foreign markets that can subsequently be transferred back to the home country

8-30

What Are The Costs Of FDI To The Home Country?

1. The home country's balance of payments can suffer
   - from the initial capital outflow required to finance the FDI
   - if the purpose of the FDI is to serve the home market from a low cost labor location
   - if the FDI is a substitute for direct exports

8-31

What Are The Costs Of FDI To The Home Country?

2. Employment may also be negatively affected if the FDI is a substitute for domestic production

- But, international trade theory suggests that home country concerns about the negative economic effects of offshore production (FDI undertaken to serve the home market) may not be valid
  - may stimulate economic growth and employment in the home country by freeing resources to specialize in activities where the home country has a comparative advantage

8-32

How Does Government Influence FDI?

- Governments can encourage outward FDI
  - government-backed insurance programs to cover major types of foreign investment risk
- Governments can restrict outward FDI
  - limit capital outflows, manipulate tax rules, or outright prohibit FDI

8-33

How Does Government Influence FDI?

- Governments can encourage inward FDI
  - offer incentives to foreign firms to invest in their countries
    - gain from the resource-transfer and employment effects of FDI, and capture FDI away from other potential host countries
- Governments can restrict inward FDI
  - use ownership restraints and performance requirements

8-34

How Do International Institutions Influence FDI?

- Until the 1990s, there was no consistent involvement by multinational institutions in the governing of FDI
- Today, the World Trade Organization is changing this by trying to establish a universal set of rules designed to promote the liberalization of FDI

8-35

What Does FDI Mean For Managers?

- Managers need to consider what trade theory implies about FDI, and the link between government policy and FDI
- The direction of FDI can be explained through the location-specific advantages argument associated with John Dunning
  - however, it does not explain why FDI is preferable to exporting or licensing, must consider internalization theory

8-36

What Does FDI Mean For Managers?

- A host government's attitude toward FDI is important in decisions about where to locate foreign production facilities and where to make a foreign direct investment
  - firms have the most bargaining power when the host government values what the firm has to offer, when the firm has multiple comparable alternatives, and when the firm has a long time to complete negotiations

8-37